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Nos. 87-453 and 87-464

In The

Supreme Court of the United States

October Term, 1987

AMERADA HESS CORP., *et al.*,
Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,
Appellee.

TEXACO INC., AND TENNECO OIL CO.,
Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,
Appellee.

ON APPEALS FROM THE SUPREME COURT OF NEW JERSEY

BRIEF OF APPELLEE IN RESPONSE TO THE UNITED STATES AS AMICUS CURIAE

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This brief is submitted by the State of New Jersey in response to the brief filed by the Solicitor General on behalf of the United States as *amicus curiae*.

THE QUESTION WHETHER THE NET INCOME BASE OF NEW JERSEY'S CORPORATION BUSINESS TAX IS GEOGRAPHICALLY SKEWED DOES NOT WARRANT PLENARY REVIEW.

The Solicitor General has concluded that New Jersey's denial of a deduction for the federal crude oil windfall profit tax ("WPT") in computing net income under New Jersey's corporate franchise tax presents a federal ques-

tion warranting plenary review, but the substance of the brief and its disagreement with the bulk of appellants' arguments establish the contrary. What is not at issue in these cases, according to the Solicitor General, leaves nothing warranting this Court's attention, specifically:

—The New Jersey provision denying a deduction for "taxes paid or accrued to the United States on or measured by profits or income" is neither facially discriminatory nor ill-motivated (SGb13);[1] contrary to appellants' views (J.S. 27), there is no discrimination in favor of non-producing independent marketers because those marketers' entitlement to deduct the WPT (as part of their cost of goods sold) does not relate to the fact that they operate in-state (*Ibid.*); denial of the deduction does not create an incentive to move oil production facilities into New Jersey, and there is no tax benefit to be gained by confining oil production to a single State (SGb14).

—Appellants "have very substantial presences in New Jersey . . . ." (SGb13).[2]

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[1] "SGb" refers to the brief of the Solicitor General.

[2] Shell had a manufacturing plant, a terminal facility, and owned 240 service stations in New Jersey. Cities Service had two refined product terminals, a research and technology laboratory, a refined product supply and distribution office, a lubes and speciality products office, an inspection station, an eastern regional office and a number of service stations. Exxon is a New Jersey corporation which had in New Jersey two chemical plants, a refinery, manufacturing plant, two chemical division sales offices, four chemical division corporate offices, two divisional offices, two corporate offices, an aircraft hangar and numerous gasoline stations. Atlantic Richfield had numerous gas stations in New Jersey. Union Oil had four chemical facilities in New Jersey and two auto/truck stops used in marketing its petroleum products. Mobil had a refinery in New Jersey, a corporate office, and 423 gasoline stations. Phillips Petroleum had a petrochemical division office and a terminal in New Jersey. Gulf had two terminals and a marketing office in New

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—Denial of a deduction for the WPT does not violate the nexus requirements of the Due Process or Commerce Clauses because, contrary to appellants, the subject matter of the tax remains some portion of overall company-wide income, and not the out-of-state activity of oil production (SGb17 and n.17).

—Because appellants' businesses are unitary, despite denial of a deduction for the WPT, the measure of New Jersey's corporation business tax may nevertheless be fairly related to state benefits (SGb17 to 18).

Having conceded the above, the Solicitor General is relegated to suggesting that New Jersey's denial of a deduction for the WPT may be constitutionally infirm only because it may violate the fair apportionment requirement of the Commerce Clause or may discriminate against interstate commerce in some fashion not plainly articulated in the Court's prior decisions (SGb15, 18).

The present record will not support an argument of unfair apportionment. As the Solicitor General points out, the Court has generally upheld varying state tax apportionment formulas against claims of double taxation, taxation of too much income, and inconsistency with other States' formulas (SGb8 to 9). *See Moorman Mfg. Co. v. Bair*, 437 *U.S.* 267 (1978). To establish that an apportionment formula operates unconstitutionally, a taxpayer must show that the amount of income apportioned to the State is "out of all appropriate proportion to the business transacted" there. *Container Corp. v. Franchise Tax Board*,

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Jersey as well as various gasoline stations. Chevron had a refinery in New Jersey, a lube oil bulk plant and owned (but did not operate) 77 retail outlets. Conoco had two sales offices, two transportation facilities, one antifreeze blending plant, and nine refined products storage facilities in New Jersey. (Pltf. Jt. App. 1133a to 1137a).

463 *U.S.* 159, 180-181 (1983). Nothing in this record suggests that the oil companies' profits attributable to New Jersey after denial of a deduction for the WPT are "out of all appropriate proportion to the business transacted" within the State. While the percentage increases in tax liability resulting from denial of a deduction for the WPT may appear large (*see* SGb23, n.24), appellants' very substantial presences in New Jersey (*see* n.2 above), indicate that their New Jersey activities contributed substantially to their overall net income. Due to the impossibility of determining precisely where the net profits of a unitary business are earned (SGb21, n.21), the increases in appellants' New Jersey tax liabilities attributable to denying a deduction for the WPT cannot be shown to be excessive. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 *U.S.* 271, 283 (1924); *Moorman Mfg. Co. v. Bair*, 437 *U.S.* at 272-274, 276. Accordingly, the constitutional requirement of fair apportionment is satisfied.

It is no more likely that denial of a deduction for the WPT skews the net income base of New Jersey's corporation business tax in such a way as to discriminate against out-of-state activities. Again, there is a problem of proof. The Solicitor General suggests that denying a deduction for the WPT skews the net income base because New Jersey "has asymmetrically included receipts without allowing deductions for associated costs" (SGb16), but there is no proof in this record as to the amount of receipts from sales of crude oil at the wellhead which were included in appellants' gross receipts for federal income tax purposes. What the record shows is that the majority of the appellants[3] sold at the wellhead between 0% and

[3] In the New Jersey courts, the so-called "Atlantic plaintiffs" included the 11 appellants, other than Amerada Hess, listed in the Jurisdictional Statement in No. 87-453, at ii, plus Diamond Shamrock.

53% of their total barrels of crude oil and exchanged between 0% and 84% of their oil. (App. 29a).[4] Nothing in the record translates these percentages into receipts for federal income tax purposes and nothing indicates whether the barrels of oil exchanged were exchanged at the wellhead or further downstream or whether the exchanges resulted in gross receipts for federal income tax purposes.[5] If there were no, or proportionately minimal, receipts from wellhead sales or exchanges included in gross receipts for federal income tax purposes, there were no or minimal such receipts in New Jersey net income, which is based on federal taxable income. *N.J.S.A.* 54:10A-4(k) (A.App.1a).[6] Denying a so-called site-specific deduction creates no distortion if there are no, or relatively minimal, site-specific receipts. Indeed, allowing a deduction for a site-specific cost where there are no corresponding site-specific receipts would result in a skewing of the tax base to the benefit of out-of-state oil production rather than its detriment. Even if some wellhead receipts entered into the tax base, the record does not establish the amount, and thus geographic skewing cannot be established. Although

[4] The data on wellhead sales and exchanges is detailed at Pltf. Jt. App. 1141a and shows that one appellant had no sales at the wellhead, eight sold between 2% and 10% of their production and that acquired from third parties, one sold approximately 12%, and one approximately 53%.

[5] The balance of appellants' crude oil production and the crude oil acquired in exchange transactions from other producers were transferred from their exploration/production divisions downstream into their refining divisions (Pltf. Jt. App. 1140a) and *see Exxon Corp. v. Department of Revenue*, 447 *U.S.* 207, 212, 225-226 (1980). Since these downstream transfers did not involve third parties but were made from one corporate division to another, they did not generate gross receipts or revenue for federal income tax purposes. 26 *C.F.R.* § 1.61-3 (a); see SGb25.

[6] "A.App." refers to the appendix to the Motion ot Dismiss or Affirm.

wellhead value may have been reflected in ultimate gross receipts realized when appellants sold their refined crude oil or petrochemical products, those downstream receipts were not wellhead receipts and accordingly were not site-specific income. *See Shell Oil Co. v. Iowa Department of Revenue*, No. 87-984, brief for the United States as *amicus curiae* at 2 to 3, 5, n.1, 6.

The Solicitor General sets forth additional reasons for not granting plenary review.

1. Similar skewing was found acceptable in *Container Corp. v. Franchise Tax Board,* (SGb16), where the taxpayer claimed that the three-factor apportionment formula, when applied to its worldwide unitary net income, systematically apportioned too much income to California because its foreign subsidiaries were significantly more profitable than its domestic operations and foreign wages were significantly lower than domestic wages. 463 *U.S.* at 181-182. Just as the Solicitor General suggests is the case here (SGb18 to 19), taxpayers doing business exclusively in California benefitted from a free ride or reduced fare by comparison to those doing business in California and abroad, and the greater Container's foreign activities, the greater was the distortion to the California net income base. The answer here, as in *Container* (463 *U.S.* at 182), is that, since appellants are unitary businesses, it is impossible to determine the geographic source of their net income or for that matter their gross receipts and thus impossible here to prove the existence of site-specific receipts.[7]

[7] While a receipt may for the sake of convenience be attributed to the State in which the sale is made, in fact, an integrated producer's receipts from the sale of crude oil at the wellhead relate substantially to its exploration, refining, manufacturing, and marketing activities in a number of States.

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2. Acceptance of appellants' position could create serious practical problems (SGb20). A few examples should make clear that appellants' proposed doctrine would be totally unworkable and that the practical problems need not be explored on plenary review.

Depletion, like the WPT, is a so-called site-specific cost incurred by the mineral extraction industry. For federal income tax purposes, there are two kinds of depletion—cost and percentage. Cost depletion, which is conceptually analogous to depreciation, permits a yearly, ratable deduction for the cost basis of a mine or well to permit the recovery over time of a producer's capital costs. *Internal Revenue Code* ("*IRC*") §§ 611 and 612. Percentage depletion is not limited to the cost basis of the mine or well but rather is computed at a specified percentage of gross income from mining. *IRC* §§ 613 and

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The Solicitor General's suggestion (SGb18) that *Westinghouse Electric Corp. v. Tully*, 466 *U.S.* 388 (1984), presented the same kind of skewing is not accurate. The tax break in *Westinghouse* increased as the *same activity* was shifted into the taxing State. Here, as the Solicitor General notes (SGb14), there is no incentive to move crude oil production into New Jersey. The fact that the tax climate in New Jersey may be less favorable than in some other State for the oil and gas production industry does not establish discrimination of the kind found in *Westinghouse*.

Nor is it accurate to equate the denial of a deduction for an out-of-state cost with the doubling of revenues received out-of-state (SGb18). A tax like New Jersey's, which is based on federal taxable income, could not be considered a net income tax if receipts were doubled. The base would no longer be net income, and unfair apportionment would be clear. Denial of a deduction in arriving at net income, however, does not destroy the net income character of the net income base because there is no single, constitutionally mandated definition of net income. *See* SGb19 to 20; *Moorman Mfg. Co. v. Bair*, 437 *U.S.* at 278-279; *Atlantic Coastline R. Co. v. Daughton*, 262 *U.S.* 413, 422, n.6 (1923).

613A. In 1975, Congress eliminated the deduction for percentage depletion in respect of most oil and gas producers, including those like appellants which refine or retail oil. *Pub.L. No.* 94-12, 94th Cong., 1st Sess., § 501(a), 89 *Stat.* 26, 47, *IRC* § 613A(d)(2) and (4). Percentage depletion continues to apply at the federal level for numerous other minerals. *IRC* § 613(b). Although a majority of the States follow the federal income tax treatment of depletion, many have their own rules. *See* generally, 1 *Multistate Corp. Income Tax Guide* (CCH) ¶ 89. Minnesota, Mississippi, Tennessee, and Wisconsin, for instance, limit all depletion to cost. *Id.* at ¶ 3208.39, ¶ 3258.17, ¶ 4158.15, and ¶ 4508.37. In each case the excess of federal percentage depletion over cost depletion must be added back to arrive at the State's net income tax base. To the extent that minerals eligible for percentage depletion under federal law are not found in these States, acceptance of appellants' position would raise the question whether denial of a deduction for percentage depletion unconstitutionally skews the net income base. On the other hand, Alabama, Louisiana and Oklahoma, which all have substantial quantities of oil production,[8] permit percentage depletion for oil and gas. *Id.* at ¶ 2058.28, ¶ 2958.47 and .73, ¶ 3858.06. Acceptance of appellants' position would raise the question whether these States are discriminating in favor of in-state oil producing activities by allowing a depletion deduction in excess of cost for minerals within their borders, while limiting the depletion deduction to cost or a lower rate of percentage depletion for out-of-state minerals.

Similar questions could be raised with respect to many States' denial of a deduction for income taxes paid to other States. *See* 1 *Multistate Corp. Income Tax Guide*

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[8] American Petroleum Institute, *Basic Petroleum Data Book, Petroleum Industry Statistics,* Vol. VIII, No. 1, Jan. 1988, Sec. IV, Table 4c.

¶ 97. For a unitary business conducting most of its operations in State A with only minimal nexus and minimal sales in the taxing State B the income tax of State A is arguably localized in that State. Must State A allow a deduction for excise taxes imposed by State B on marijuana if State A has no marijuana within its borders, or expenses of operating the gaming tables at a casino in State B if casino gambling is illegal in State A? Must New Jersey, for that matter, amend its Corporation Business Tax Act to provide that the WPT is deductible when the existing provision is facially unobjectionable, singles out no federal tax for special treatment, and applies to the WPT simply because the latter is a tax "on or measured by profits or income"?

The Solicitor General doubts that "interest payments on an integrated company's debts should be considered site-specific" (SGb21), but would that be so with respect to mortgage interest on a particular parcel of out-of-state property? How could the doctrine be limited to out-of-state costs which are treated differently if incurred in-state? A copper producer denied a deduction for out-of-state copper severance taxes (SGb22) would suffer the same alleged distortion to its net income base as these appellants, and the fact that the taxing State also denied a deduction for coal severance taxes and had coal mines within its borders would not cure the distortion for that particular taxpayer. The Solicitor General suggests that "a State where significant oil production occurs could deny deductions for specified oil production costs . . . ." (*Ibid.*). Is this Court to be called on to decide whether a State has a sufficiently large quantity of crude oil production to permit it to deny a deduction for crude oil production costs? Appellants presumably believe that New York's crude oil production of 853,000 barrels in 1986 (*Basic Petroleum Data Book,* Sec. IV, Table 4c) is not sufficient to permit it to deny a deduction for the WPT.

Cf. App. 88a. Was North Dakota's 1980 crude oil production of 40,337,000 barrels sufficient to entitle it to limit the WPT deduction in that year? *See* App. 88a to 89a. Could Florida with 9,383,000 barrels of crude oil in 1986 deny a deduction for the WPT, or Pennsylvania with 3,783,000 barrels? *Ibid.* What if a State had proved reserves but had not yet begun production?

The Solicitor General's suggestion that the doctrine would apply only where the geographic skewing was "of significant magnitude" and "obvious" is fraught with the same uncertainties. How large would the skewing have to be to violate the Constitution? Has the WPT deduction declined to such an extent due to falling crude oil prices (*see* Mot. to Aff. at 10 to 11 and n.8) that it is no longer of constitutional magnitude? Would the discrepancy between percentage and cost depletion be sufficiently small in some cases to be constitutionally acceptable? Is the Court's appellate docket to include cases questioning whether the alleged skewing is sufficiently large to be unconstitutional?[9]

[9] The Solicitor General argues that, because the WPT resembles a severance tax which New Jersey allows as a deduction, the net income base may be impermissibly skewed (SGb23 to 28), but the mere fact that New Jersey allows a deduction for some so-called out-of-state costs, e.g., severance taxes, and denies a deduction for another, e.g. the WPT, does not, standing alone, present a constitutional problem because no in-state activity is necessarily favored by that dichotomy. If a State were required to treat all comparable out-of-state costs identically, no State could follow the federal treatment of depletion (percentage depletion for hard minerals and cost for oil and gas) if the minerals were out-of-state. While explaining why the WPT is not identical to the federal income tax, the Solicitor General does not explain that the WPT is also unlike a typical severance tax. Although there are some exceptions, the large majority of state severance taxes do not permit deductions from gross proceeds or value in arriving at the tax base. *See* 2 *State*

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Added to the (1) lack of evidence suggesting either unfair apportionment or geographic skewing, (2) the Court's treatment of similar in-state/out-of-state effects (SGb14,n.14) in *Container*, and (3) the enormous practical difficulties of applying the proposed doctrine, are the considerations set forth in the Motion to Affirm:

—Due to the varying provisions in state tax laws and the variety of costs and expenses which those laws allow or disallow, a decision here could not set forth an unvarying constitutional rule for the future.

—The WPT is to start phasing out in January 1991 (*IRC* § 4990(c)(3)) if not sooner repealed,[10] and worldwide crude oil prices have dropped to the point where there is little incentive for the States to deny a deduction for the WPT.

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Tax Guide (CCH) ¶¶ 45,200 to 45,955. The WPT is invariably a net amount—the removal price (sales price or posted price) less the adjusted base price (controlled price in the particular field), adjusted for inflation and adjusted by the incremental state severance taxes paid on the windfall profit. *IRC* §§ 4988(a), 4989(a) and (b), 4996(c). Moreover, the taxable windfall profit cannot exceed 90% of the net income per barrel, and in computing net income per barrel, virtually all economic costs are deductible. *IRC* § 4988(b); 26 *C.F.R.* § 1.613-5(a). In short, the WPT is a unique tax, insufficiently analogous to a typical severance tax to establish that New Jersey is discriminating against interstate commerce by treating the WPT and severance taxes differently, and the Solicitor General's implications to the contrary exhibit a basic misunderstanding of how the WPT operates.

[10] On February 23, 1988, Senator Domenici introduced S.2096, which, among other things, would repeal the WPT. 100th Cong., 2d Sess., 134 *Cong. Rec.* S1421 (Feb. 23, 1988); *see* Tax Analysts, *Tax Notes*, Feb. 29, 1988. The President has recommended repeal of the tax. "President's 1988 Legislative & Administrative Message to Congress," *Tax Notes*, Feb. 1, 1988.

Finally, the Solicitor General is unable to conclude whether denying a deduction for the WPT is or is not constitutional (SGb24). Such uncertainty, along with the problems of proof set forth above and the inconclusiveness of any rule which the Court might announce, demonstrate conclusively that these cases are not appropriate for plenary review.

CONCLUSION

For the foregoing reasons, probable jurisdiction should not be noted.

Respectfully submitted,

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